TR 93/27 - Income tax: basis of assessment of interest derived and incurred by financial institutions

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Australian Taxation Office

Taxation Ruling
Income tax: basis of assessment of interest derived and incurred by financial institutions

other Rulings on this topic

IT 2017; IT 2051; IT 2227; IT 2513

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This Ruling, to the extent that it is capable of being a 'public ruling' in terms of Part IVAAA of the ***Taxation Administration Act 1953****, is a public ruling for the purposes of that Part . Taxation Ruling TR 92/1 explains when a Ruling is a public ruling and how it is binding on the Commissioner.*

What this Ruling is about

1. This Ruling clarifies when interest income is derived by a financial institution and when interest payable by a financial institution is allowable as a deduction for the purposes of the *Income Tax Assessment Act 1936* ('the Act').

2. The types of financial instruments and investments to which this Ruling applies include:

- overdrafts, term loans, personal and other loans;
- interest bearing deposits;
- and securities issued or held by financial institutions.

3. This Ruling does not apply to interest rate swaps of the kind discussed in Taxation Rulings IT 2050 and 2682 nor does it have any application to 'qualifying securities' as defined in subsection 159GP(1) in Division 16E of Part III of the Act. Further, this Ruling does not apply to bills of exchange, promissory notes and other commercial paper issued at a discount to which Division 16E does not apply (for example, by reason of their term being less than twelve months). Taxation Ruling TR 93/21 sets out our views as to the timing of deductions for discounts on short-term bills of exchange and promissory notes following the decision in *Coles Myer Finance Limited v. F C of T* ('*Coles Myer Finance*') 93 ATC 4214; (1993) 25 ATR 95.

4. Timing issues in respect of interest derived by taxpayers that invest in fixed and variable interest securities, where such securities

are purchased or sold cum interest rights, will be the subject of a separate Ruling.

5. Clarification of the appropriate time to return income and claim deductions for interest received and paid in advance by financial institutions will be the subject of a separate Ruling.

6. The term 'financial institution' has a restricted meaning for the purposes of this Ruling. Accordingly, this Ruling only applies to taxpayers that principally, and in the ordinary course of their business operations, derive assessable income by lending or investing funds obtained by way of deposit or borrowing. Generally speaking, taxpayers that are not moneylenders are excluded from the application of this Ruling.

Ruling

7. The common law rule is that interest accrues *de die in diem* (day by day). The straight line daily accruals method of accounting for interest income and interest expense generally adopted by financial institutions reflects that principle and is in accordance with generally accepted accounting practice in Australia.

8. The adoption of straight line daily accruals as the basis of tax accounting for interest derived and incurred results in 'a substantially correct reflex' of the taxable income of a financial institution.

9. Accordingly, the straight line daily accruals method is the appropriate basis on which financial institutions should bring interest income and expense to account for taxation purposes where the terms and conditions of the relevant contract indicate that the parties do not intend to disturb the ordinary rule that interest accrues on a daily basis over the period of the investment.

10. We understand that some financial institutions use other methods of measuring interest income in respect of a small portion of their loan portfolios. Such methods may provide a similar result to that achieved under the straight line daily accruals method. Decisions as to the acceptability of alternative income measurement methods will be made on a case by case basis.

Date of effect

11. Subject to what is said at paragraphs 12 to 13, this Ruling applies (subject to any limitations imposed by statute) for years of

income commencing both before and after the date on which it is issued.

12. To the extent that this Ruling is concerned with changes in interpretation, those changes operate in favour of taxpayers. Consequently, where a financial institution has previously relied on written advice from the ATO in adopting a method other than straight line daily accruals for returning interest income, this Ruling will only apply to that institution from and including the 1992-3 income tax year unless the institution asks that it apply (subject to any limitations imposed by statute) to earlier income years.

13. This Ruling does not apply to financial institutions to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Explanations

Definition of a 'Financial Institution'

14. The Australian Accounting Research Foundation discussion paper, *'Financial Reporting by Financial Institutions and Accounting for Financial Instruments'*, Discussion Paper No. 14 (1990) by Phillip Hancock, defines 'financial institutions' (at paragraph 1.03) to be:

> '...any institution, one of whose principal activities is to take deposits and borrow, with the objective of lending and investing and includes all the following types of institutions:
>
> Banks
> Merchant banks
> Finance companies
> Building societies
> Credit unions
> Pastoral finance companies
> Life insurance offices
> General insurance offices
> Pension and superannuation funds
> Friendly societies
> Cash management trusts
> Co-operative housing schemes.'

15. However, in this Ruling a distinction is drawn between taxpayers that carry on business as financiers by taking deposits and borrowing funds and then on-lending or investing those funds for income earning purposes, and those taxpayers that invest substantial

amounts of money as part of their income earning activity but do not finance their operations to any significant extent with borrowed funds. In the latter case funds are raised by way of equity or premiums which, by their nature, do not involve any interest expense. That is, borrowings play no, or only a limited, part in the business activities of the enterprise. The distinction is best illustrated by examining the difference between the operations of a bank and a building society compared with an insurance company.

16. The activities of a bank include accepting deposits from customers (with such deposits carrying interest); the payment of withdrawals on demand by customers; obtaining other funds by way of borrowing; and investing and lending deposited money and other borrowed funds. In *Commercial Banking Co. of Sydney Limited v. F C of T* (1950) 81 CLR 263 Dixon J (as he then was) discussed the activities of a trading bank. He concluded (at CLR 304) that:

> 'A banker's business may be said to be that of dealing in money.'

17. In *Case P52* (1964) 14 TBRD 236; 11 CTBR (NS) 437 *Case 75* Mr R.C. Smith (Member), after referring to these remarks of Dixon J, added (at TBRD 237; CTBR 439):

> '...and in my opinion these words apply equally to the business of a savings bank as to that of a trading bank.'

18. In holding that the principal business of a bank was the lending of money, Dixon J in the *Commercial Banking Co. of Sydney case* said (supra at CLR 304):

> 'The profit-making side of his (a banker's) activities is in putting out the money so as to increase it, and *that substantially means to obtain interest*. If attention is riveted upon the relations of the banker to his customer and the amount of work done in that respect it might be thought that to say that the principal business consists of the lending of money is to ignore all the business done with customers whose accounts are in credit as well as much else besides. *But if attention is riveted on the activities of banking in which the money is used or laid out it would seem correct to say that the decisively profit-making side of the business is concerned with the lending of money.'* (Emphasis added).

19. Further, the No. 3 Board of Review in *Case F26* 74 ATC 132 at 155; (1974) 19 CTBR (NS) 291 *Case 44* found that the investment operations of a building society and its day to day dealings with its customers were for all practical purposes indistinguishable from much of the business of a savings bank.

20. In *F C of T v. Australian Mutual Provident Society* (1953) 88 CLR 450 the High Court rejected the argument put by a mutual life assurance company that its principal business was the lending of money. In the following passage from the joint judgment of Dixon CJ, Williams, Fullager and Kitto JJ (at 463-4), their Honours illustrate the distinction between the business of a bank and an insurance company:

> 'In the *Commercial Banking Co.'s Case* it was held that the principal business of a bank was the lending of money. The Society maintains that its principal business also is the lending of money. The argument was, in our opinion, rightly rejected by the board. The Society's principal business is the business of life assurance, that is to say, the making and performance of contracts to pay, in consideration of *premiums* paid to it, sums of money on death or on the expiration of a period. *Its business differs radically from that of a banker. The lending of money is of the essence of the business of a banker.* He provides many other facilities for his cusomers, *but it may be said to be the characteristic of his business that he borrows money in order to lend it.* If he ceased to lend money, the nature of his business (assuming it to survive) would radically change. *A life assurance company lends money, and its lendings are very important, but they are not the essence of its business. They are operations ancillary to the main business,* made primarily because the holding of large funds to cover contingent liabilities is a necessity of that business. If a life assurance company ceased to lend money, the nature of its business would not change. The position would simply be that it would have to charge larger premiums in order to maintain itself in a sound position. Interest derived by a life assurance company on money lent by it is, in our opinion, *income from property and not income from personal exertion.*' (Emphasis added)

21. Hence, a 'financial institution' for the purposes of this Ruling is a taxpayer that principally, and in the ordinary course of its business operations, derives assessable income by lending or investing funds obtained by way of deposit or borrowing. Generally speaking, taxpayers that are not moneylenders are excluded from the application of this Ruling.

22. Taxpayers that clearly fall within the restricted meaning of 'financial institution' used in this Ruling include banks, merchant banks, finance companies (including 'in-house' finance companies), building societies, credit unions and moneylenders. Taxpayers that do

not fall within the restricted meaning of 'financial institution' used in this Ruling include insurance companies (both general and life), approved deposit funds, friendly societies and superannuation funds.

23. Some doubt may exist in particular cases as to whether this Ruling applies to a group holding company lending money to a subsidiary or other 'in-house' finance company. For the purposes of paragraph 63(1)(b) of the Act we accept that a moneylender need not necessarily be ready and willing to lend moneys to the public at large or to a wide class of borrowers. It would be sufficient if the taxpayer lends moneys to certain classes of borrowers provided it does so in a business-like manner with a view to yielding a profit from it. See generally paragraphs 42 to 46 of Taxation Ruling TR 92/18.

The Nature of Interest

24. An appreciation of the the nature of interest is important in determining the time at which interest income is derived and interest expense incurred by a financial institution for taxation purposes (cf. *Coles Myer Finance,* at ATC 4222, ATR 105; *F C of T v. Australian Guarantee Corporation* ('*AGC*') 84 ATC 4642 at 4658-4660; (1984) 15 ATR 982 at 1002-5.

25. Whilst 'interest' is given a specific meaning in a number of provisions of the Act its meaning is not defined for the purposes of the Act generally. It is therefore necessary to have regard to the nature of interest at common law.

26. Interest is money agreed to be paid on a loan or an amount payable as damages for the non-payment of a debt or other sum of money on the proper day. Further, interest is calculated at a rate proportionate to the amount of principal and to the time during which the non-payment continues. See Jowitt's *Dictionary of English Law,* 2nd edition.

27. At law interest accrues day by day (that is, *de die in diem*) even if payable only at intervals (cf. *The State of South Australia v. The Commonwealth of Australia* 92 ATC 4066 at 4072; (1992) 23 ATR 10 at 19). Interest is therefore apportionable under the general law in respect of time (cf. *Halsbury's Laws of England*, 4th ed., Vol. 32 at para 106; Vol. 16 at para 1250; *Conveyancing Act 1919 (NSW)*, subsection 144(1)).

28. In *F C of T v. The Myer Emporium Limited* (1987) 163 CLR 199 the Full High Court restated a basic concept of interest. At page 218 it stated:

> '...interest is regarded as flowing from the principal sum (*Federal Wharf Co. Ltd v. DFCT* (1930) 44 CLR 24 at 28)

> and to be compensation to the lender for being kept out of the use and enjoyment of the principal sum: *Riches v. Westminster Bank Limited* (1947) AC 390 at 400.'

29. Moreover, the courts have also regarded interest as a reward earned for the service of lending, the interest being earned as money is left outstanding (cf. *Commissioner of Inland Revenue v. The National Bank of New Zealand* 77 ATC 6001 at 6023, 6026 & 6032; (1977) 7 ATR 282 at 295, 298 & 306; *Willingale (H. M. Inspector of Taxes) v. International Commercial Bank Limited* ('*Willingale*') (1978) 52 TC 242 at 271).

30. It also appears that the common law principle that interest accumulates day by day may be overridden by the terms of a suitably worded loan agreement (cf. *AGC*, supra, per Beaumont J at ATC 4659-60; ATR 1004-5; *Willingale,* supra, per Lord Fraser of Tullybelton at TC 273).

Time of Deductibility of Interest Expenditure

31. To determine when an outgoing is deductible under subsection 51(1) it is necessary to determine when that outgoing is 'incurred'.

32. Generally speaking, the Courts have held that a loss or outgoing is incurred in the year in which a taxpayer comes under a presently existing liability to pay a pecuniary sum. That is, the loss or outgoing must be a presently existing pecuniary obligation that has become due irrespective of whether it is payable now or in the future: *F C of T v. James Flood Pty Limited* (1953) 88 CLR 492 at 506; *Nilsen Development Laboratories Pty Limited & Ors v. F C of T* 81 ATC 4031 at 4034-7; (1981) 11 ATR 505 at 508-12; *AGC*, supra at ATC 4658; ATR 1002. The approach to be taken is a jurisprudential analysis of subsection 51(1): *Coles Myer Finance*, supra at ATC 4221 & 4227-8; ATR 103 & 112-3.

33. However, it is not enough to establish the existence of a loss or outgoing actually incurred. It must be a loss or outgoing of a revenue character and it must be 'properly referable', 'properly attributable' or 'fairly referable' to the relevant year of income (cf. *Coles Myer Finance*, supra at ATC 4221, ATR 104; *New Zealand Flax Investments Ltd v. F C of T* ('*New Zealand Flax*') (1938) 61 CLR 179 at 207; *AGC*, supra at ATC 4650, ATR 992).

34. Accordingly, the Courts have demonstrated a willingness to apportion a net loss or outgoing over the profit making period to which it relates. This is consistent with the accounting concept commonly referred to as the 'matching principle'. (See para. 11 of

Statement of Accounting Standard AAS 9: Expenditure Carried Forward to Subsequent Accounting Periods).

35. In *Coles Myer Finance* a net loss or outgoing which represented the cost of acquiring funds that were put to profitable advantage over a period that crossed two income years was apportioned over that period. The taxpayer carried on business as financier to the Coles Myer group of companies. In the year ended 30 June 1984 the taxpayer drew, and sold at less than their face values, bills of exchange and promissory notes. The total face value of the bills and notes outstanding at 30 June 1984 was $110,000,000 and they were discounted by way of sale for a total of $105,264,527. The capital acquired by the discounting transactions provided funds that were used by the taxpayer in carrying on the business of lending monies to other members of the Coles Myer group. The taxpayer claimed a deduction for the discount expense of $4,735,472 in the 1984 income year even though it did not have to make any payments until the instruments matured in the 1985 income year.

36. The Full High Court, by majority (Mason CJ, Brennan, Dawson, Toohey and Gaudron JJ, Deane J agreeing), found that in the 1984 income year the taxpayer company had a present legal liability to pay in a future year the face value of the bills and notes. This established that the taxpayer had 'incurred' in that year an obligation to pay an amount which 'gives rise to' a net loss or outgoing.

37. The Court considered it proper, in ascertaining the taxpayer's net income or profit for a particular year, to set against the taxpayer's gross income or profit for that period the net losses or outgoings referable to that period. The apportionment of the discount cost over the two years of income to which the notes and bills related accorded with accounting principle and practice and the view that subsection 51(1) is a statutory recognition and application of the matching principle of accountancy (cf. *Coles Myer Finance*, supra at ATC 4222, ATR 105-6; *RACV Insurance Pty Limited v. F C of T* 74 ATC 4169 at 4181; (1974) 4 ATR 610 at 623).

38. The decision in *Coles Myer Finance* is consistent with the need to obtain 'a substantially correct reflex' of the finance company's true taxable income (cf. *The Commissioner of Taxes (South Australia) v. The Executor, Trustee and Agency Company of South Australia Limited* ('*Carden's case*') (1938) 63 CLR 108 at 154). At ATC 4222-3, ATR 106, the Court used an example of long term (10 year) bills to illustrate the distortion of the taxpayer's operations on revenue account that would occur if a deduction for the discount expense was allowable in the year such bills were drawn. (See also Deane J at ATC 4225-6, ATR 110-1).

39. Whilst *Coles Myer Finance* was a case involving the discount expense of a finance company the Court considered (at ATC 4222; ATR 105) that, in effect 'the discount offered by the taxpayer is the cost of acquiring the funds which it turns over in its business, the amount of the discount serving the same purpose as the amount of interest on borrowed moneys...'.

40. Support for the view that financial institutions should adopt the daily accruals basis of claiming interest expense may also be found in *Alliance Holdings Limited v. F C of T* ('*Alliance Holdings*') 81 ATC 4637; (1981) 12 ATR 509 and in *AGC* (supra). Both cases involved finance companies and dealt with the timing of deductions for interest expense under subsection 51(1). Both companies accounted for their income and expenditure on an accruals basis. The interest on the relevant debentures was not credited or paid to the debenture holders but credited to an accrued interest account.

41. In both cases the courts found a presently existing liability and then turned to generally accepted accounting practice and the matching principle for assistance in allocating the deductible interest expense to a particular income tax period.

42. As was the case in *Alliance Holdings*, the Full Federal Court decision in *AGC* appears to have been particularly influenced by the nature of the activities carried on by the taxpayer. The taxpayer in *AGC* was a subsidiary of a bank that carried on business as a financier. The taxpayer's business entailed making secured and unsecured advances and the provision of financial accommodation to its customers. The taxpayer borrowed funds in a number of ways in order to provide funds to its customers. Toohey J said (supra at ATC 4649; ATR 991):

> 'The notion of "matching " is of particular relevance in the present case because of the taxpayer's general activities in the borrowing and lending of money.'

43. When the matter originally came before the Supreme Court of New South Wales as *Australian Guarantee Corporation Limited v. F C of T* 84 ATC 4024; (1983) 15 ATR 53, Lee J referred to the common law rule that interest accrues on a daily basis. His Honour acknowledged the authorities which state that accounting principles cannot be determinitive as to when an outgoing is 'incurred' for tax purposes but then stated (supra, at ATC 4033-4; ATR 65):

> 'But a conclusion that, where there is a presently existing liability to pay interest in the future, the amount of interest accruing each year, up to the date of maturity, is "incurred" during the respective years, does not mean that accounting practice is being used as a substitute for the true meaning

> of "incurred" in subsection 51(1). All it means is that accounting practice is identifying in respect of that liability, which is a present liability to pay the *whole* of the interest at a future time, *the amount which is to be treated as an outgoing "incurred" during each year of income...* In this situation it seems to me that accounting practice can be resorted to to identify *the extent* to which a presently existing liability to be discharged in another year, should be treated as an "outgoing incurred" in the year of income.' (Emphasis added)

And later (at ATC 4034; ATR 66):

> 'In the present case accountancy practice looks to the existing liability to pay the *whole* of the interest in the future, and shows *the manner in which part of that liability may be appropriately treated as an expense "incurred" during each year of income.*' (Emphasis added)

44. In dismissing the Commissioner's subsequent appeal, the Full Federal Court concluded that the method by which the taxpayer had calculated the amount of accrued interest expense referable to a particular income tax year should be accepted. Toohey J had regard to the relevance of accountancy concepts and principles in determining the appropriate amount to be deducted in each year. He said (supra at ATC 4649; ATR 992):

> 'This Court should be slow to disallow a method of calculating the amount of an outgoing *if what is claimed is fairly referable to the year in question*. In my view, the amount claimed by the taxpayer as interest on deferred interest debentures for the year ended 30 September 1978 was an outgoing incurred by the taxpayer in the relevant year. *It was calculated in accordance with sound accounting practice, designed to give a true picture of the taxpayer's financial operations, and it was an approach not precluded by the language of the Act*. It is insufficient objection to that approach to say that it is not known when interest will in fact be paid. The amount claimed as a deduction was, in terms of subsection 51(1), incurred in the relevant year in the sense that the taxpayer subjected itself to a liability which it assessed according to *a method fairly designed to reflect the extent of the liability for the year in question*.' (Emphasis added)

45. McGregor J also appears to have found accountancy practice persuasive. In finding for the taxpayer his Honour observed (supra, at ATC 4657; ATR 1001):

> '... the accountancy evidence here was used and, with respect, correctly, by the learned primary Judge in reaching his decision. With due deference I am similarly assisted.'

46. The decisions in *New Zealand Flax, Carden's case*, *Alliance Holdings, AGC* and *Coles Myer Finance* suggest that deductions for interest incurred by financial institutions should reflect the extent of the liability that is properly referable to the year of income. The Courts look to the actual appropriateness of the accounting method used in determining the correct basis of tax accounting to be adopted in the circumstances. Moreover, the Courts are reluctant to reject a method that is consistent with business conceptions of what is the true expense incurred, and is reasonable and consistent in its application.

47. Straight line daily accruals is the generally accepted accounting method for reflecting the common law nature of interest and allocating interest expenditure to relevant periods. Apportioning deductions for interest on a daily accruals basis over the period of a borrowing is seen as appropriate, both in terms of matching income and expenses and providing a correct reflex of a financial institution's taxable income. Therefore, subject to the terms and conditions of the relevant loan agreement not disturbing the common law rule that interest accrues on a day by day basis, allowable deductions for interest incurred by financial institutions should be measured using the straight line daily accruals method.

Time of Derivation of Interest Income

48. In determining at what point of time interest receivable by a financial institution is assessable under subsection 25(1) it is necessary to determine when the interest is 'derived'. The Act does not define the word 'derived' and does not establish a method to be adopted as a general rule to determine the amount of income derived by a taxpayer.

49. The time at which income is derived for tax purposes depends, in part, upon the nature of the taxpayer's income producing activity: *Carden's case* (supra). It is also well established that unless the Act makes some specific provision on the point, the amount of income derived is to be determined by the application of ordinary business and commercial principles, and that the method of accounting to be adopted depends upon its actual appropriateness as a method which is 'calculated to give a substantially correct reflex of the taxpayer's true income': *Carden's case*, supra at CLR 154; *Brent v. F C of T* 71 ATC 4195 at 4200; (1971) 2 ATR 563 at 570).

50. The relevance of accountancy and business practice in determining when 'suspended interest' was derived by a bank was addressed by the New Zealand Court of Appeal in *Commissioner of*

Inland Revenue v. The National Bank of New Zealand (supra). In that case the Court had regard to the judgment of Dixon J in *Carden's case* as well as various other Australian cases. Cooke J summed up his view of the authorities in the following terms:

> 'Taken as a whole the Australian cases show that accountancy evidence may be important, and they emphasise that in every case the ideal is what Dixon J called "a substantially correct reflex" of the particular taxpayer's income...'

51. While the courts have described interest as being 'earned' (refer to the earlier discussion on this point at paragraph 29), the term 'earned' is not necessarily equivalent in meaning to 'derived' (cf. *Brent v. F C of T*, supra at ATC 4200; ATR 570). Nevertheless, when considering the conditions under which deferred interest debentures issued by the taxpayer would earn interest for their holders in the *AGC* case, Beaumont J discussed the receipt of interest in the following terms (at ATC 4659; ATR 1003):

> 'In *In re Rogers' Trusts* (1860) 1 Dr. & Sm. 338; 62 ER 408, Sir R.T. Kindersley V.-C., in holding that interest was apportionable, said (at Dr. & Sm. p. 341; ER p. 409):
>
> > "In the present case the interest payable on the debentures, though payable half-yearly, is not an entirety, but is an accumulation of each day's interest, which accrues *de die in diem*; and which, though not presently payable, is still due."
>
> 'It must be accepted, as Lord Russell of Killowen observed in *Willingale*... that "earn" is not a word of universal application in the same sense in all circumstances. In its relevant dictionary meaning, "earn" means "to gain as a due return or profit" (*Macquarie Dictionary*). But the immediate question is one of timing, namely to determine when the interest was "earned", and the ordinary meaning of "earn" is equivocal in that sense: it describes the fact of gaining a return without necessarily indicating the period to which it is referable.
>
> 'Although the bare statement that interest is, or will be, "earned" is not itself determinative of the time at which or the period during which interest will be derived, ordinarily, *where interest is accruing from day to day, it is, I think, appropriate to describe that interest as being "earned" on such a daily basis in point of time, even if not payable until a later date. Further, in my opinion, the period in which interest is accruing due may properly be*

> *regarded as the period in which interest is thus being earned*.' (Emphasis added)

52. The commercial accounts of trading operations do not represent the primary position from which an investigation of income for taxation purposes begins (cf. *Commissioner of Inland Revenue v. The National Bank of New Zealand*, supra at ATC 6016; ATR 286). The decision in *F C of T v. Thorogood* (1927) 40 CLR 454 supports the view that there is no principle of law that makes bookkeeping entries decisive when derivation of income is in issue. The correct approach is to take into consideration 'sensible business considerations' (per Starke J in *Perrott v. D C of T (NSW)* (1922) 40 CLR 450 at 454) and to use 'business good sense': *Arthur Murray (NSW) Pty Limited v. F C of T* ('*Arthur Murray*') (1965) 114 CLR 314 at 319.

53. Where the matter is not specifically addressed by legislation the authorities establish that the relevant tax accounting method is a question of law to be determined on the facts of the particular case. While commercial and accountancy practice cannot be substituted for the tests contained in the relevant provisions of the Act, the Courts have found it appropriate to place reliance upon the concepts of business and the principles and practices of accountancy in the ascertainment of income and expenditure. That is, although ordinary accounting principles and practice are not determinative of the issue, they are nevertheless relevant and may be influential. See, for example, *Coles Myer Finance* at ATC 4222, ATR 105-6; *F C of T v. James Flood Pty Limited*, supra at CLR 506-7; *Carden's case*, supra per Dixon J at CLR 152-3; *Arthur Murray*, supra at CLR 318; *Henderson v. F C of T* (1970) 119 CLR 612; *AGC*, supra per Toohey J at ATC 4649; ATR 992; *F C of T v. Dunn* 89 ATC 4141 at 4148; (1989) 20 ATR 356 at 363; *Hooker Rex Pty Limited v. F C of T* 88 ATC 4392; (1988) 19 ATR 1241 per Sweeney and Gummow JJ at ATC 4399; ATR 1248; and *F C of T v. Firstenberg* 76 ATC 4141; (1976) 6 ATR 297.

54. The High Court gave considerable weight to accounting practice in *Arthur Murray* (supra) when considering whether money received in advance of services to be rendered (dancing lessons) was derived for the purposes of subsection 25(1) of the Act. The Court noted that income derivation involves more than the ascertainment of book-keeping methods. It also expressed the view (at CLR 318):

> 'The ultimate inquiry... must be whether that which has taken place, be it the earning or the receipt, is enough by itself to satisfy the general understanding among practical business people of what constitutes a derivation of income. A conclusion as to what that understanding is may be assisted by considering standard accountancy methods, for

> they have been evolved in the business community for the very purpose of reflecting received opinions as to the sound view to take of particular kinds of items.'

See also *RACV Insurance Pty Limited v. F C of T* (supra); *Commercial Union Assurance Company of Australia Ltd v. F C of T* 77 ATC 4186; (1977) 7 ATR 435; *International Nickel Australia Limited v. F C of T* (1977) 137 CLR 347 at 366-7; *F C of T v. Cyclone Scaffolding Pty Limited* 87 ATC 5083; (1987) 19 ATR 674).

55. Moreover, the relevance of established accounting and commercial principles in determining when income is derived does not diminish even though two or more generally accepted methods may exist in practice (cf. *F C of T v. Australian Gaslight Co.* 83 ATC 4800 at 4806; (1983) 15 ATR 105 at 112).

56. Accounting practice has changed over the years to reflect the increasing complexity of financial transactions and the greater reliance on credit. (See, for example, *Henderson v. F C of T*, supra per Windeyer J at CLR 626). However, while accountancy methods have changed, the fundamental accounting principle of matching revenue and expenses in order to give a true reflection of an entity's performance over specified periods has not altered. For example, public entities are bound to adopt existing accounting standards in the recognition of income for reporting purposes. Those standards require that income should be brought to account on an accrual basis so as to match income with the period to which it is attributable. 'Accrual basis' for the purposes of the accounting standards means that items are brought to account as they are earned or incurred (and not as money is received or paid) and included in the financial statements for the accounting periods to which they relate (*Approved Accounting Standard ASRB 1001: Accounting Policies - Disclosure*; *Australian Accounting Standard AAS 6: Accounting Policies: Determination, Application and Disclosure*).

57. Paragraphs 24 to 30 of this Ruling explain the common law principle that interest accrues *de die in diem* (day by day). The daily accruals method of accounting for interest income generally adopted by financial institutions reflects that principle and is in accordance with generally accepted accounting practice in Australia.

58. Subject to the terms of the agreement between the parties not disturbing the ordinary rule that interest accrues on a day by day basis, the authorities support the view that for financial institutions, interest arising from the making of loans and investments generally accrues as income earned on a daily basis. Accordingly, where interest is accruing due to a financial institution on a daily basis then it is derived by that financial institution daily even though it may not be receivable until a later date. The dates specified in the contract for the payment

of interest by the client of the financial institution are dates which are used for the convenience of both the client and financial institution, detailing when the payments are to be paid or credited/received or receivable. In most contracts the interest is an accumulation of each day's interest which accrues, and though not presently payable, is still due.

59. In other words, interest income may be derived on a daily accruals basis notwithstanding that the payment of interest has been deferred or, in the words of Barwick CJ in *Henderson v. F C of T*, supra at CLR 651, notwithstanding that the borrower has been afforded a period of time to pay. Modern accounting and commercial principles and practice reflect the common law nature of interest and therefore support the view that interest income is derived by a financial institution for taxation purposes as it accrues on a day by day basis.

60. Straight line daily accruals is the appropriate method for a financial institution to bring to account interest income for taxation purposes where the terms and conditions of the relevant contract indicate that the parties do not intend to disturb the ordinary rule that interest accrues on a daily basis over the period of an investment.

61. We understand that some financial institutions use other methods of measuring interest income in respect of a small portion of their loan portfolios. For example, the 'T + 1/2' method is sometimes applied in measuring interest income derived from portfolios of small value loans. Such methods may provide a similar result to that achieved under the straight line daily accruals method. Decisions as to the acceptability of alternative income measurement methods will be made on a case by case basis.

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